



87-SBE-045

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)  
RAYMOND J. AND LILLIAN I. LULL ) No. 81A-870-GO  
83A-549

Appearances:

For Appellants: R. James Church  
Certified Public Accountant

For Respondent: Grace Lawson  
Counsel

O P I N I O N

These appeals are made pursuant to section 18593<sup>1</sup>/ of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Raymond J. and Lillian I. Lull against proposed assessments of additional personal income tax in the amounts of \$1,280.18, \$6,720.67, \$3,647.72, and \$3,300.63 for the years 1976, 1977, 1978, and 1979, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

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The main issues for decision are as follows:<sup>2/</sup>

(1) Whether there was a bargain sale of property to appellants by **Maecon, Inc.**, in 1976, thereby triggering constructive dividend treatment to them.

(2) Whether withdrawals from **Maecon, Inc.**, by appellants were bona fide loans or constructive dividends to them.

(3) Whether a tax-deferred exchange between appellants and **Maecon, Inc.**, in 1977, **resulted in** the receipt of boot by appellants, thereby triggering the recognition of gain realized to the extent of the boot received, and if so, what was the correct amount.

(4) Whether respondent properly adjusted depreciation deductions taken by appellants in 1978 and 1979.

(5) Whether respondent properly disallowed interest deductions claimed by appellants for payments allegedly made to **Maecon, Inc.**, in 1979.

These **appeals** are companion cases to the Appeal of **Maecon, Inc.**, decided this same day. Appellants are the owners of 51.6 percent of the issued and outstanding shares of **Maecon, Inc.** (hereinafter ~~as~~ **Maecon**). The above issues primarily involve dealings the appellants had with **Maecon** and will be dealt with in sequence.

∴ (1) **Bargain Sale**

In 1973, **Maecon** purchased a lot for \$29,096 in an **arm's-length** transaction. In 1976, **Maecon** sold that same lot to appellants **for** what it had paid **for it** in 1973 - \$29,096. **Upon** audit, respondent concluded that appellants had paid less than **fair** market value **for** the lot and that they had received a constructive dividend to the extent of the difference **between** the price they paid and the fair market value of the property. Initially, respondent determined that the fair market **value of** the lot in 1976 had increased 40 percent over the purchase price in 1973. Eowever, after appellants provided county

7 Computational questions, such as tax preference liability and capital loss carry forward eligibility in 1978, have been raised but such questions are answered by the resolution of the major issues.

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property tax statements indicating that the county assessor had increased the value of the lot by 5.7 percent over the same period, respondent revised its estimate of the fair market value of the lot in 1976 to eight percent over its original cost to the corporation. (**Resp. Br.**, Nov. 19, 1982, at **8.**)

Respondent argues that its "estimate of increased fair market value should be determined to be correct as county assessors' estimates of fair market value are normally conservative." (**Resp. Br.**, Nov. 18, 1982, at **8.**) Notwithstanding respondent's lower adjustment, appellants maintain that no bargain sale occurred between them and the corporation. Appellants argue that had **Maecon** sold that property to someone other than them, in an **arm's-length** transaction, a real estate commission and other closing costs would have been incurred by **Maecon** so that the net to the corporation would have actually been less than what appellants paid the corporation in 1976. For example, if **Maecon** had sold the subject property to an unrelated third party in a typical **arm's-length** transaction at the respondent's value of \$31,422 (\$29,096 plus eight percent), and paid standard closing costs and a real estate commission approximating a total of ten percent, the net proceeds to the corporation would have been \$28,281 or about \$1,000 less than what it actually received from appellants. Accordingly, appellants conclude that the net price that the corporation received was at or near the "net" market value of the property in 1976, and, as a consequence, no bargain sale occurred. (**App. Br.**, July 5, 1983, at 2.1

It is, of course, well settled that when a corporation sells corporate property to its shareholder for less than its fair market value, it is engaging in a distribution of property constituting a dividend unless some specific statutory exception applies. (Appeals of Arcadia Industries, Inc., et al., Cal. St. Bd. of Equal., April 6, 1977.) Since no exceptions have been advanced, we are called upon to address the primary factual question of the fair market value of the subject property in 1976. Based upon the evidence presented, we cannot conclude that **Maecon** transferred the subject property to appellants in 1976 for less than its fair market value. First, as noted above, **Maecon** likely netted more through its sale to appellants than it would have in an **arm's-length** sale to some third person at respondent's value. Second, respondent admits that the determination of fair market value is only an estimate. It seems to us that **Maecon's** calculation of the value of the property in 1976

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is within close range of whatever its "real value" was at the time and, certainly, in that light, reasonable. Lastly, the purpose for finding constructive dividends in cases where corporations transfer assets to shareholders at less than fair market value is to prevent the transfer of retained earnings to shareholders without dividend treatment. By not having to pay closing costs and a real estate commission, **Maecon** has actually preserved its retained earnings for future dividends to its shareholders and the subject sale **was**, therefore, not **abusive**. Accordingly, based upon the above, we must find that the sales price in 1976 approximated its fair market value and, as a result, no bargain sale occurred. Accordingly, respondent must be reversed on this **issue**.

**(2) Advances**

During the years at **issue**, **Xaecon** made various advances to appellants which they contend were loans. **Maecon** had four different accounts which documented certain advances to its shareholders. Three of these accounts showed repayments over time of the amounts withdrawn. **However, account number 111** showed continuous withdrawals over a number of years with an increasing balance. The balances due **Maecon** from account number 111 were approximately as follows:

R. Lull

|             |           |
|-------------|-----------|
| <b>1976</b> | \$137,082 |
| 1977        | 146,349   |
| 1978        | 167,384   |
| 1979        | 188,735   |

**During the years at issue, appellants did not** repay the **purported loans or interest thereon** reflected by **account number 111**. While **Maecon** had substantial retained earnings it declared no dividends. Upon audit, respondent treated all the advances reflected in account number 111 as constructive dividends to appellants rather than loans.

**On appeal**, appellants contend **that** the advances reflected by account number 111 were bona fide loans. Appellants argue that, during the **years** at issue, the advances were treated as loans on the corporation's books, interest **was** accrued yearly, demand notes were issued, there was an intention to repay **the advances**, and part of the advances reflected in other accounts were, in fact, repaid. Moreover, **appellants** argue that **Maecon**

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required a large retained earnings account in order to maintain its active operations. In contrast, respondent notes that, in spite of the large amount of retained earnings, no dividends were declared.

The question of whether appellants' withdrawals are to be **characterized** as dividends or loans depends on all the facts and circumstances surrounding the **transac-** tions between them and the corporation. (Wiese v. Commissioner, 35 B.T.A. 701, affd., 93 **F.2d** 921 (8th Cir.), cert. den., 304 U.S. 562 [**82 L.Ed. 1529**] (1938).) Specifically, the question is whether at the time of each withdrawal there existed an intent by each shareholder to **repay** the purported loan and by the corporation to enforce the obligation. (Commissioner v. Makransky, 321 **F.2d** 598 (3d Cir. 1963).) Furthermore, **special scrutiny** of the situation is invited where the withdrawer is in substantial control of the corporation (Haber v. Commissioner, 52 T.C. 255 (1969)) and withdrawals under such circumstances are deemed to be dividend distributions unless the controlling stockholder can affirmatively establish their character as loans. (Wilson v. Commissioner, 10 T.C. 251, affd. sub. nom., Wilson Bros. & Co. v. Commissioner, 170 **F.2d** 423 (9th Cir. 1948).)

We can attribute little significance in the resolution of this matter to the formalities noted by appellants. First, appellants point out that notes were executed and that this is a generally accepted indicator that a bona fide loan existed. However, such notes were demand notes with no fixed schedule for repayment. We have held before that such instruments contribute little as evidence of genuine indebtedness. (Appeal of William R. and May R. Horn, Cal. St. Bd. of Equal., May 19, 1981.) Second, appellants **argue** that **Maecon** carried the accounts as loans and interest was accrued. However, as indicated above, it has never been established that appellants ever, in fact, paid any interest to **Maecon**. Furthermore, no evidence has been presented which would indicate that a definite time and manner of repayment was specified.

Appellants argue that **Maecon** did not declare any dividends because it had to maintain large retained earnings in order to sustain its operations. However, there is no substantiation of this **allegation** in the record. The lack of both declared **dividends** and adequate indicia of a genuine indebtedness lead us to conclude that the withdrawals of funds **were not** bona fide loans,

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but were taxable constructive dividends. Accordingly, respondent's action *must* be sustained on this issue.

(3) Boot and Determination of Gain

On November 30, 1977, **Maecon** exchanged vacant land (hereinafter "**Harbor Island**") for land owned by appellants which contained a rental building (hereinafter "**Via Lido Sound**") in a section 18081 tax **deferred** exchange. The Via Lido Sound property was immediately sold by **Maecon** to an unrelated third party in an arm's length transaction for \$250,000. While on August 1, 1977, **Maecon** had contracted for a house to be built on the Harbor Island property, work progress records indicate that by November 1977, only \$274 in construction costs had been incurred by **Maecon**. (**Resp. Br.**, May 8, 1984, Bx. C-3.) To **balance out** the equities between the two properties exchanged, **Maecon** made a \$90,000 advance payment to the builder on November 28, 1977. In addition, appellant had previously received \$10,000 from **Maecon** for an option to purchase the Via Lido Sound property.

The \$90,000 payment was considered to be part of the like kind exchange by appellants so that no gain was recognized. **However**, respondent determined that the \$90,000 payment was 'boot' to the extent of the gain realized by appellants on the exchange. **Moreover**, respondent determined that **consideration** received by **appellants** for tie-option was **part** of the consideration received in the exchange and was also boot. On appeal, appellants **only address** the \$90,000 payment by **Xaecon** and argue that such payment was **for** construction incurred (per invoice) and brought the equities of the exchange **properties** into approximate equality: (**App. Br.**, May 5, 1985, at 2.)

It is, of course, well settled that in a tax deferred exchange, *if a taxpayer* receives "**other property**" or "**boot**" in addition to the like-kind property permitted to be received without recognition of gain, the **gain**, if any, will be recognized to the extent of the **lesser** of gain realized or the boot received. (*See Treas. Reg. §1.1031(b)-1.*) The exchange of real property for a contract to construct a new plant has been found not to be an exchange of like-kind properties but "**other property**" or boot to the extent of the value of the contract. -(*Bloomington Coca-Cola B. Co. v. Commissioner*, 189 F.2d 14 (7th Cir. 1951)) Accordingly, to the extent that **Maecon** made an advance payment to the

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contractors for construction on the Harbor Island property, appellants received other property or boot. **Appellants** have offered no evidence that the construction had taken place prior to the exchange. We must, therefore, find that the \$90,000 payment was an advance payment at the time of the exchange and, as such, constituted other property or boot. Moreover, it is well settled that payment for an option to purchase is income to a seller when the option is exercised. (**Aiken v. Commissioner**, 35 F.2d 620 (8th Cir. 1929), *aff'd* 282 U.S. 275 (1931).) Accordingly, at the time of the exchange, income realized **by** appellants would include that derived from the option. Since the consideration received **for** that option was cash, such sum would also constitute boot, the gain from which would be recognizable.

Based on the above, respondent's determination with respect to the receipt of boot in the amount of \$100,000 by appellants must be sustained. Next, we must consider the tax effect to appellants of the receipt of such boot.

In **order** to determine the tax effect to appellants of such boot, the gain realized from the transaction must be determined, which, in turn, requires that the fair market values of the properties exchanged be determined. Since there was apparently no appraisal of either property at the time of exchange, this determination of the values of the properties would appear to present some difficulty. As will be recalled, the Via Lido Sound property which, initially, belonged to appellants was sold by **Maecon** immediately after the exchange to an unrelated third party in an **arm's-length** transaction for \$250,000.

Respondent admits that the fair market value of the Harbor Island property "might appear" to be established from that sales price. (**Resp. Br.**, May 8, 1984, at **12.**) However, respondent appears to question the significance of this sale for **establishing** the value of the equities exchanged and, derivatively, the fair market value of the properties involved. Respondent argues that the comparison between the two properties' assessed valuations and mortgages carried against such properties indicates that the value of the Harbor Island property should be higher. (**Resp. Br.**, May 8, 1984, at 12: Ex. A-6.) However, based **upon the** evidence presented, we conclude that the best indication of value with respect to the exchange is established by the admitted **arm's-length** sale of the Via Lido Sound property immediately

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after the exchange. Accordingly, we find that the fair market value of the properties exchanged and, **derivatively**, the gain realized from the exchange must be based upon that sale (Via Lido Sound for \$250,000) and that the respondent's determination of gain to be recognized must be modified in accordance with this finding.

(4) Depreciation Adjustments

In 1978, appellants spent **over** \$240,000 to construct **and** furnish a rental house on the Harbor Island property. Appellants' records indicate that the house was rented in October 1978, but that construction continued during 1979. On their tax return for 1978, the depreciable life of the house was shown to be 25 years and depreciation for a full year was taken on the 200 percent double declining balance method.

Upon audit, respondent increased the life of the house to 35 years and allowed depreciation only from October 1978. Moreover, depreciation was allowed on the furniture and on a dock for only three-months rather than for a full year. (**Resp. Br.**, May 8, 1984, at 6; **Ex. A-9 & A-10.**) On appeal, appellants argue that "[t]he life selected of **25** is certainly not unreasonable: (**App. Br.**, May 5, 1985, at 5.) Moreover, they argue that since the property was under construction in July of 1977, it was available for use in the first quarter of 1978 so that a full year's depreciation in 1978 is warranted. Appellants note that the construction that continued until 1979 was not for items that prevented the house from being rented. **However**, appellants have submitted no evidence which would establish the useful life of the house at **25** years or that it was available for use in early 1978.

It **is**, of course, well settled that respondent's determination with respect to the proper depreciation allowance is presumed correct. In Appeal of Peninsula Savings and Loan Association, **decided by** this board January 2, 1974, we stated at page 3 of the original **opinion**:

Under California law as under federal law the taxing authority's determination of a proper depreciation allowance carries with it a presumption of correctness, and the burden of showing the determination to be incorrect is on the taxpayer. (Hotel De Soto Co., T.C. Memo, April 5, 1945; Appeal of Frank Miratti,



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Inc., Cal. St. Bd. of Equal., July 23, 1953; Appeal of Continental Lodge, Cal. St. Bd. of Equal., May 10, 1967.) Here appellant has offered nothing but an unsupported statement that a **25-year** life is reasonable in view of the highly competitive nature of the savings and loan business. This is not enough to satisfy the burden placed on the taxpayer, and we must sustain respondent's action in requiring the use of longer useful lives in calculating allowable depreciation.

As indicated above, appellants have offered nothing but unsupported statements that a **25-year** useful life is reasonable and that the property was available for rent in early 1978. This is not enough to sustain their burden and we must, accordingly, sustain respondent's action with respect to calculating allowable depreciation.

**(5) Interest**

**Maecon's** corporate records indicate that it accrued an interest payment of \$22,479 in 1979 which was denoted as payment for interest. Although appellants deducted this sum on their 1979 tax return as interest expense, upon audit, they were unable to substantiate such payment. Accordingly, respondent disallowed the deduction.

It is well settled that respondent's determination is presumed to be correct and that the burden is **upon** the taxpayer to prove it erroneous. (Appeal of Janice Rule, Cal. St. Bd. of Equal., Oct. 6, 1976.) Furthermore, unsupported statements do not overcome this presumption. (Appeal of Clyde L. and Josephine Chadwick, Cal. St. Bd. of Equal., Feb. 15, 1972.) Appellants have presented *no* evidence substantiating such payment. Instead, appellants merely conclude that "[t]he amount was paid for the accrued interest and was a proper deduction for 1979." (App. Br., May 5, 1985, at 3.) In light of such unsupported statements, we must find that appellants have not met their burden with respect to this issue and that respondent's determination must be upheld.

Based upon the foregoing; respondent's determination must be modified in accordance with this opinion.'

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS **HEREBY** ORDERED, ADJUDGED **AND** DECREED, pursuant to section 18595 of the Revenue and Taxation **Code**, that the action of the Franchise Tax Board on the protests of Raymond J. and Lillian I. Lull against proposed assessments of additional personal income tax in the amounts of **\$1,280.18, \$6,720.67, \$3,647.72, and \$3,300.63** for the years 1976, 1977, 1978, and 1979, respectively, be and the same is hereby modified in **accordance** with this opinion. In all other respects, the action of the Franchise Tax Board is sustained.

**Done** at Sacramento, California, this 17th day of June , 1987, by the State Board of **Equalization**, with Board Members Mr. Collis, **Mr. Dronenburg**, Mr. Bennett, Mr. Carpenter and **Ms. Baker** present.

Conway H. Collis , Chairman

Ernest J. Dronenburg, Jr. , Member

William M. Bennett , Member

Paul Carpenter , Member

Anne Baker\* , Member

\*For Gray Davis, per Government Code section 7.9